# Øystein Olsen: The conduct of monetary policy

Introductory statement by Mr Øystein Olsen, Governor of Norges Bank (Central Bank of Norway), at the hearing before the Standing Committee on Finance and Economic Affairs of the Storting (Norwegian parliament), Oslo, 20 May 2011.

*Please note that the text below may differ from the actual presentation. The statement is based on Norges Bank's Annual Report for 2010, Monetary Policy Report 1/11 and the Executive Board's assessments in the period to the monetary policy meeting on 12 May.*

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I would like to thank the Chairman of the Committee and also thank the Committee for this opportunity to report on the conduct of monetary policy in connection with the Storting's deliberations on the Government's Financial Market Report. My statement here today is based on the Bank's Annual Report, but also on the Executive Board's assessments for the period to the most recent monetary policy meeting and new information. I also refer to this year's report from Norges Bank Watch, a group of experts that evaluates Norges Bank's conduct of monetary policy.

## 1. Activity in the Norwegian economy has gained a firm footing

The global financial crisis that unfolded in 2008 gave rise to the most severe economic downturn of our time. There was a dramatic decline in international trade, and in the following year world GDP decreased for the first time in generations.

Although global economic growth has recovered, the outlook remains uncertain. For a long time we have observed the increasing prominence of China and other emerging economies in the global economy. These countries also weathered the crisis well and have helped to restart economic growth in several western countries. However, the global trade imbalances that accumulated prior to the financial crisis are still present. Several countries must sharply reduce public expenditure to bring rapidly rising government debt under control. This may have a dampening impact on growth ahead. High commodity prices could also depress activity.

*Chart: Consumer prices*

Strong growth in demand for energy and commodities from emerging economies has led to a marked rise in the price of oil, grain and other commodities. In addition, unrest in North Africa and the Middle East has fuelled uncertainty concerning the supply of oil ahead. Food and energy represent a large share of consumption in many countries and inflation has therefore picked up. Nevertheless, in most advanced economies long-term inflation expectations are relatively stable and consumer price inflation is being dampened by low capacity utilisation and high unemployment.

*Chart: Actual and expected key rates*

Key rates are near zero in many countries. Through 2010 interest rate expectations in other countries fell, but have picked up in 2011. The ECB and Sveriges Riksbank recently raised their key rates. Rising inflation has led to monetary policy tightening in several emerging economies.

*Chart: Output*

Activity in the Norwegian economy has gained a firm footing. Capacity utilisation appears to be close to a normal level. According to preliminary national accounts figures, mainland GDP grew by 2.2% from 2009 to 2010. Norges Bank's regional network contacts expect solid growth to continue in the coming quarters. Unemployment is low. There are prospects of fairly strong growth in the Norwegian economy ahead, driven by solid income growth and an increasing population.

*Chart: Population growth*

In 2010, the population grew by 1.3 per cent. With the exception of 2008, this is the highest rate of population growth since 1920. A high birth rate has contributed, but strong population growth primarily reflects high inward migration. This is boosting demand for goods and services, including housing. Nonetheless, it is likely that a high proportion of labour immigration will enable the economy to grow faster without fuelling price and wage pressures, even though bottlenecks may arise in some areas.

*Chart: Consumer prices 2010/11*

The rise in consumer prices slowed through 2010, and in recent months inflation has been fairly low. Inflation has varied from month to month as a result of wide fluctuations in electricity prices. Overall CPI inflation rose by 2.5 per cent in 2010. If we exclude fluctuations in energy prices, the rise in prices has been low. In 2010, CPIXE inflation was 1.7 per cent.

*Chart: Interest rate forecasts*

Norges Bank raised its key policy rate to 2 per cent in May 2010. Through 2010 the Bank's interest rate forecast was adjusted down, and further increases were deferred. Prospects for lower inflation, a weaker growth outlook and lower interest rates abroad were underlying factors. In the course of spring 2011, it has become clear that the upturn in the Norwegian economy has gained a firm footing. There is a rising shortage of labour and cost inflation is picking up. The subdued rise in import prices, combined with the krone appreciation, has resulted in a slower rise in prices for imported consumer goods. With the Norwegian economy's current solid pace of growth, inflation is nonetheless expected to pick up further ahead. At our meeting on12 May, we decided to raise the key policy rate by 0.25 percentage points to 2.25% to take into account the consideration of stabilising inflation and activity further ahead.

*Chart: Krone exchange rate – I-44*

The krone is strong, reflecting favourable prospects for the Norwegian economy and high oil prices. When oil market conditions normalise, some of the krone appreciation can be expected to be reversed. Norges Bank does not operate with a target for the krone exchange rate, and the krone shows fairly wide fluctuations. With high growth in demand for goods and services and rising price and cost inflation, there is also a risk of a further appreciation of the krone. A strong krone dampens inflation through a subdued rise in prices for imported goods and services. Persistent low inflation could curb the rise in the key policy rate.

*Chart: Price and cost levels relative to trading partners*

Price and cost levels in Norway relative to trading partners have weakened Norway's competitive position in recent years. So far this has not been an obstacle to solid growth and near-normal capacity utilisation in the Norwegian economy, partly as a result of high prices for many of our exports. Nevertheless, we should bear in mind that a high cost level makes us vulnerable, particularly in the event of any renewed downturn in the global economy.

*Chart: Oil price (Brent Blend)*

The Norwegian economy emerged quickly and fairly painlessly from the global economic downturn partly owing to high prices for oil and other commodities. Norway's terms of trade have improved further. High commodity prices and strong growth in emerging economies are an advantage for both commodity-based industries and high-technology export firms. Norwegian exports are increasing. Unemployment is slightly lower than expected and it appears that wage growth in 2011 will be somewhat higher than envisaged in the March Monetary Policy Report. Norway has been fortunate, but effective systems for managing high revenues have probably also played a role.

## 2. A decade of inflation targeting

*Chart: Inflation*

A decade has passed since the inflation targeting regime was introduced. Inflation has varied in this period, although less so than previously, and has generally been close to target. Inflation expectations now seem to be firmly anchored. This shows that monetary policy has been effective. At the same time, over these ten years, we have gained insight into the functioning of the Norwegian economy under an inflation targeting regime. Inflation targeting is flexible, i.e. when setting the key policy rate, weight is also given to stabilising developments in output and employment.

For monetary policy to contribute to stabilising developments in output and employment, there must be confidence that the inflation target will be reached. Inflation will not be at target at all times, but if there is confidence in monetary policy, expected inflation will be close to the inflation target over time, which in itself contributes to stabilising inflation.

Norges Bank's communication of monetary policy aims to stabilise inflation expectations by giving the reasons for and explaining interest rate setting. By publishing its interest rate forecasts and monetary policy strategy, Norges Bank has made it easier for others to understand and evaluate monetary policy. It is my objective to continue and enhance the Bank's analysis and communication. Since March of this year our monetary policy reports have included a summary of the Executive Board's discussion of monetary policy prior to the reports.

*Chart: Surplus liquidity in the banking system*

To be effective, the key policy rate must have an impact on market rates. Norges Bank supplies liquidity to banks to bring short-term money market rates down closer to the key policy rate. Surplus liquidity in the banking system is kept as sight deposits at Norges Bank.

The redistribution of interbank liquidity does not function adequately. In 2010 Norges Bank had to maintain high liquidity in the banking system to keep short-term money market rates close to the key policy rate. To dampen demand for central bank liquidity and promote increased activity in the money market, Norges Bank's Executive Board approved changes in the system for managing liquidity in the banking system in December 2010. Under the new regulation, only a certain amount of banks' deposits – a quota – will bear interest at the key policy rate. Deposits in excess of this quota will bear a lower interest rate. This will give banks a stronger financial incentive to redistribute liquidity among themselves, making the Norwegian money market function more effectively. The new system is expected to take effect from 3 October of this year.

## 3. From financial crisis to debt crisis

*Chart: General government gross debt*

The experience of recent years has shown the costs of financial instability in many countries. Global economic growth has recovered, but the effects of the financial crisis are still visible and will be so for some time ahead.

Financial crises tend to be followed by debt crises. Fiscal policy was used actively in most countries to dampen the effects of the financial crisis. The mistakes of the 1930s were not to be repeated. But as a result, weak public balances became even weaker. On top of this, some countries provided substantial government funding to banks. Government debt quickly mounted.

The situation came to a head in several euro area countries, initially in Greece, which had allowed deficits to creep up during the growth period. In the next round, Ireland and Portugal also came under pressure. They have had to rely on loans from the EU and the IMF with attendant economic programmes to stabilise and then reduce government debt. Government bond yields in these countries have continued to rise. Particularly with regard to Greece, there is renewed focus on the capacity to manage large fiscal deficits and rising government debt.

Norway differs substantially from countries with high public debt. With ample state coffers, the Norwegian economy was to a considerable extent insulated from the effects of the financial crisis in 2008 and 2009. Norway has had room for manoeuvre because solid government finances secure credibility and because inflation expectations are firmly anchored. The oil fund mechanism curbs the effects of oil price fluctuations on the economy.

The Norwegian economy has enjoyed the benefits of a disciplined fiscal policy. The fiscal rule has functioned effectively.

*Chart: Household debt*

There is one area in which Norway differs from other countries in a manner we perhaps do not like: Norwegian households are among the most heavily indebted in Europe.

Household debt growth in Norway has edged down, but the level of debt shows no sign of falling. There is reason to keep a close eye on developments in these areas.

*Chart: Level of debt high for many households*

Direct losses associated with loans to households are seldom large in Norway. Even during the banking crisis 20 years ago, losses were limited. However, historically low losses are no guarantee of low losses in the future.

A mutually reinforcing dynamic of rising debt and increasing property prices characterises the run-up to financial crises. Higher property prices lead to higher collateral values for loans. With easier access to credit, purchasing power increases.

The household debt burden is now higher than prior to the banking crisis. The increase has been highest for middle and lower income groups (deciles). The number of households with a very high debt burden is also far higher. The number is sufficiently high to engender negative spillover effects in the economy in the event of an abrupt change in household behaviour.

Such spillover effects may in their turn affect bank losses, which is the main reason that the work on financial stability places particular emphasis on developments in the household sector.

While monetary policy and fiscal policy have been anchored within a long-term, operational framework over the past ten years, there has been no comparable, coherent regulatory system for financial markets. Requirements are currently imposed on individual banks, but without adequate regard to overall risk in the financial system. This became clear during the financial crisis.

New regulations are underway. The new Basel III framework aims to establish a long-term framework for financial market regulation that lays the basis for a robust financial system. The new regulatory framework will make it more costly for banks to expand rapidly. Moreover, the new framework includes macro-prudential measures that can be triggered when necessary. Basel III includes a countercyclical capital buffer that requires banks to set aside more capital against their loans. This will increase their capacity to absorb future losses, which to some extent can also dampen credit growth during an upturn. In today’s situation in Norway, with elevated debt burdens and high and rising house prices, a countercyclical capital buffer would have been a useful instrument.

*Chart: Inflation*

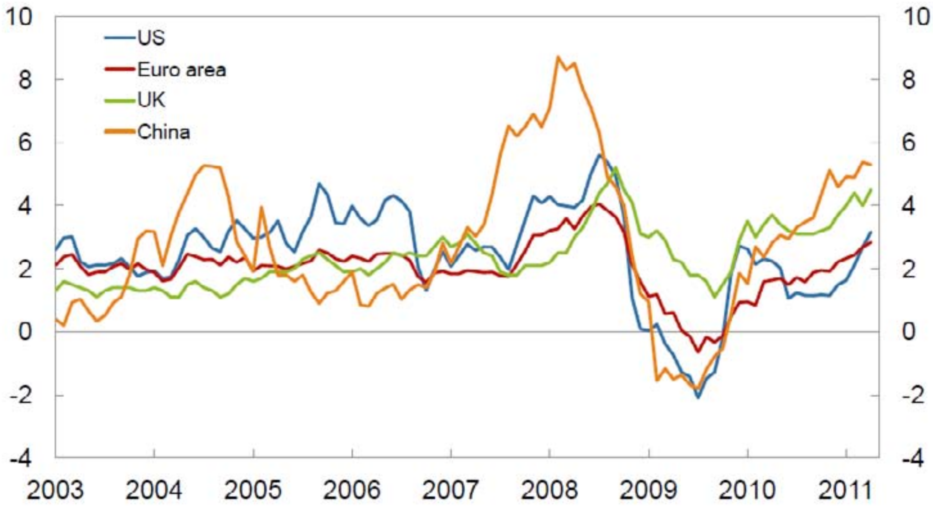
The interest rate affects general economic developments, including the housing market and other conditions that have implications for financial stability. Experience indicates that monetary policy alone cannot ensure stable economic developments. The objective of monetary policy is low and stable inflation, and we only have one instrument – the key policy rate. There are limits to the number of considerations the interest rate can bear. We therefore need more targeted instruments to dampen the build-up of risk in the financial system. The interest rate also has effects on other asset prices, such as the krone exchange rate. A monetary policy that aims at bringing down the value of domestic assets can easily push the value of the krone in the opposite direction.

In interest rate setting we can never lose sight of the primary objective of monetary policy, which is low and stable inflation.

Thank you for your attention.

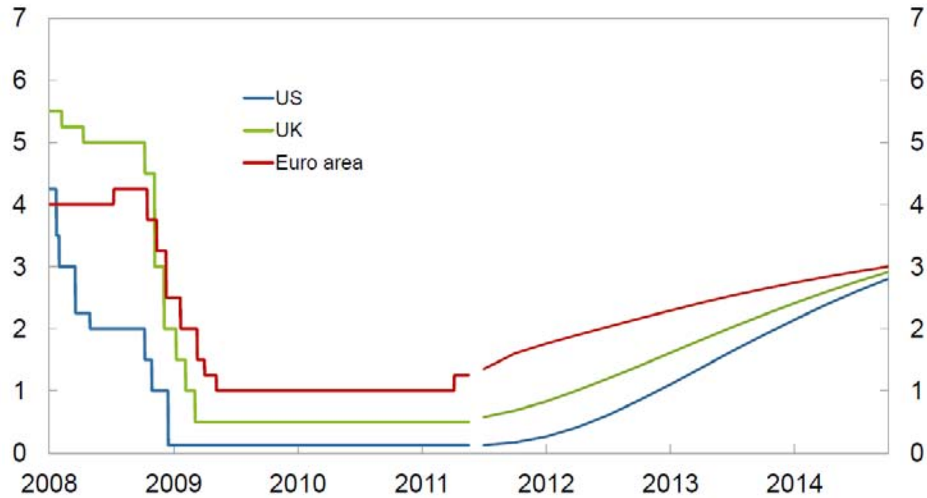
## Consumer prices

12-month change. Per cent. January 2003–April 2011




Source: Thomson Reuters

## Key rates and estimated forward rates as at 18 May 2011[1] Per cent. 1 January 2008–31 December 2014[2]



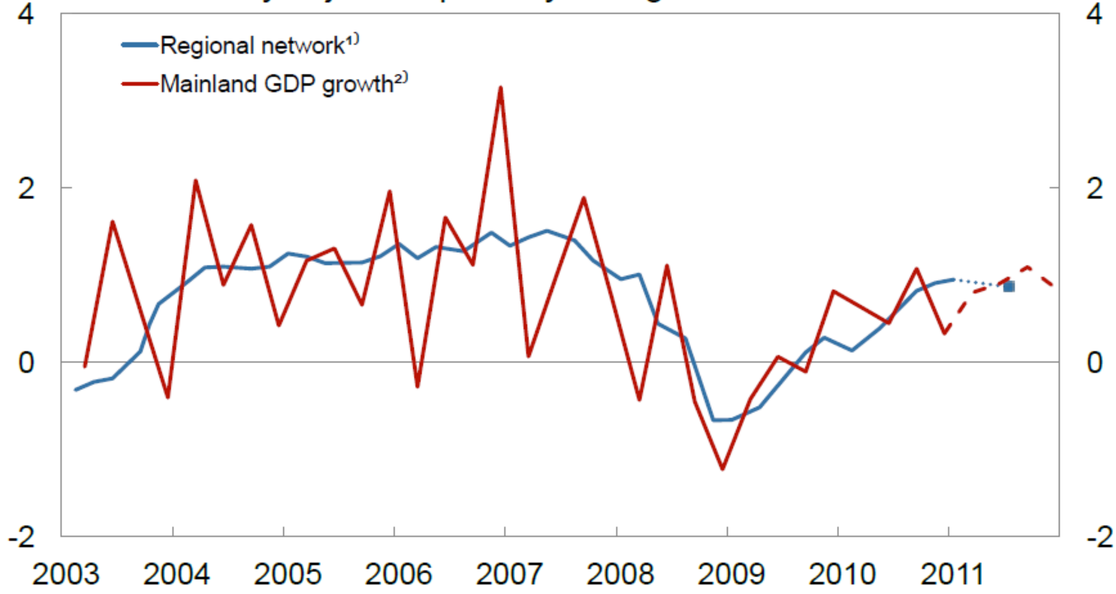

1) Thin lines show estimated forward rates at 18 May 2011. Forward rates are based on Overnight Indexed Swap (OIS) rates

2) Daily figures from 1 January 2008 and quarterly figures as at 18 May 2011

Sources: Bloomberg L.P. and Norges Bank

# Output

GDP mainland Norway and Norges Bank's regional network indicator of changes in output past three months and expected change in output next six months. Seasonally adjusted quarterly change. Per cent. 2003 Q1–2011 Q4

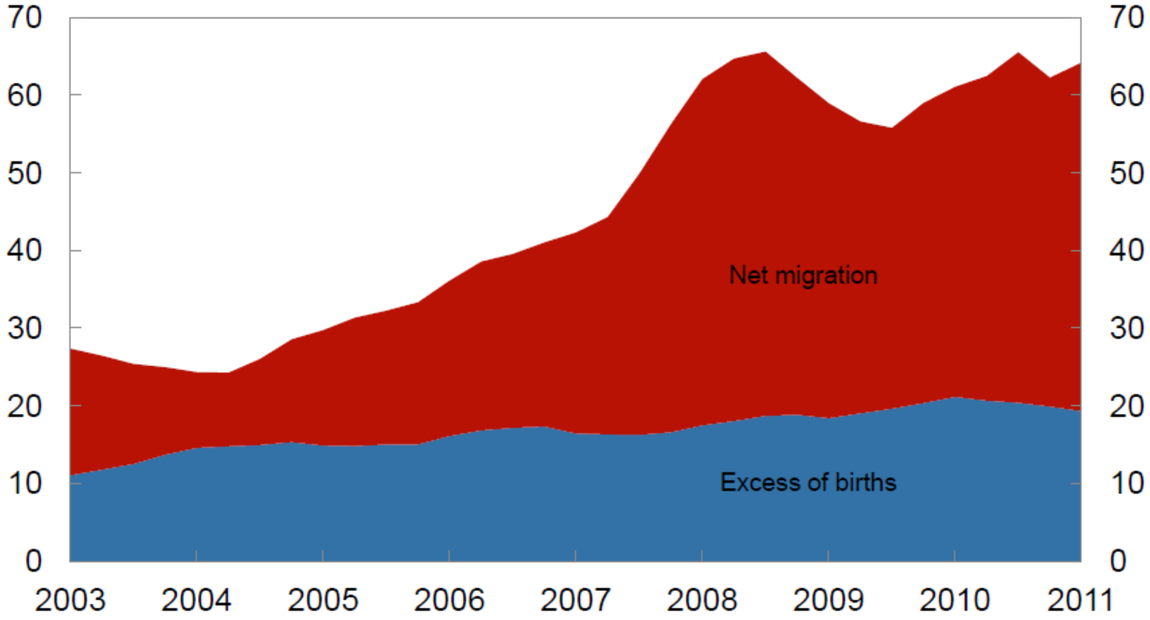



1) Projections 6 months ahead from January 2011
2) Projections for 2011 Q1–2011 Q4 from *Monetary Policy Report* 1/11 (broken line)

Sources: Statistics Norway and Norges Bank

# Population growth

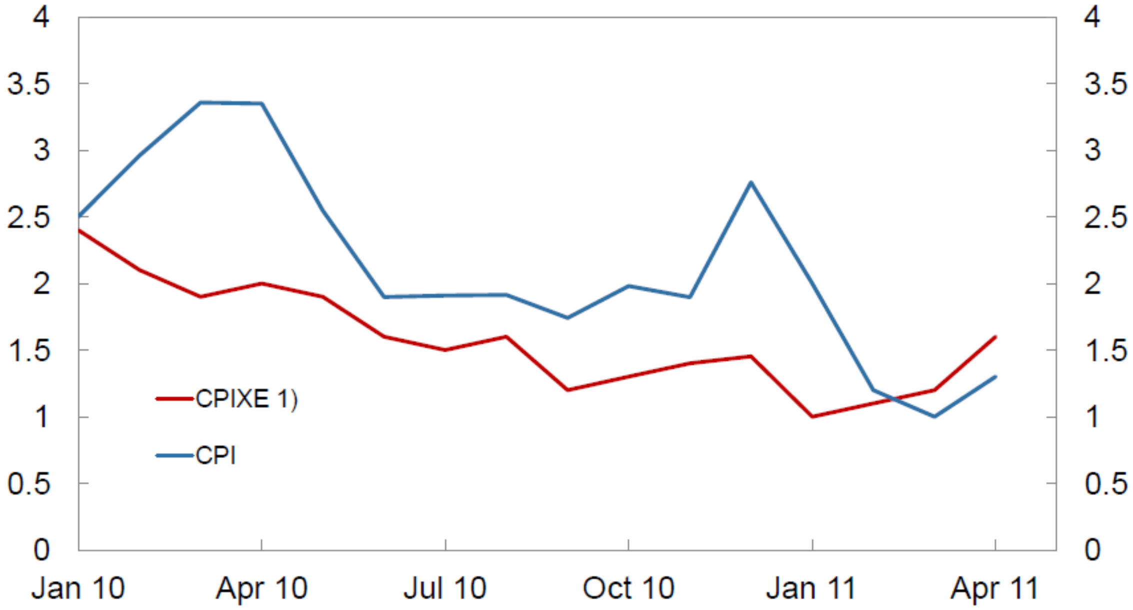
Sum of four previous quarters. 1000 persons. 2003 Q1–2011 Q1




Sources: Statistics Norway and Norges Bank

## Consumer prices

12-month change. Per cent. January 2010–April 2011

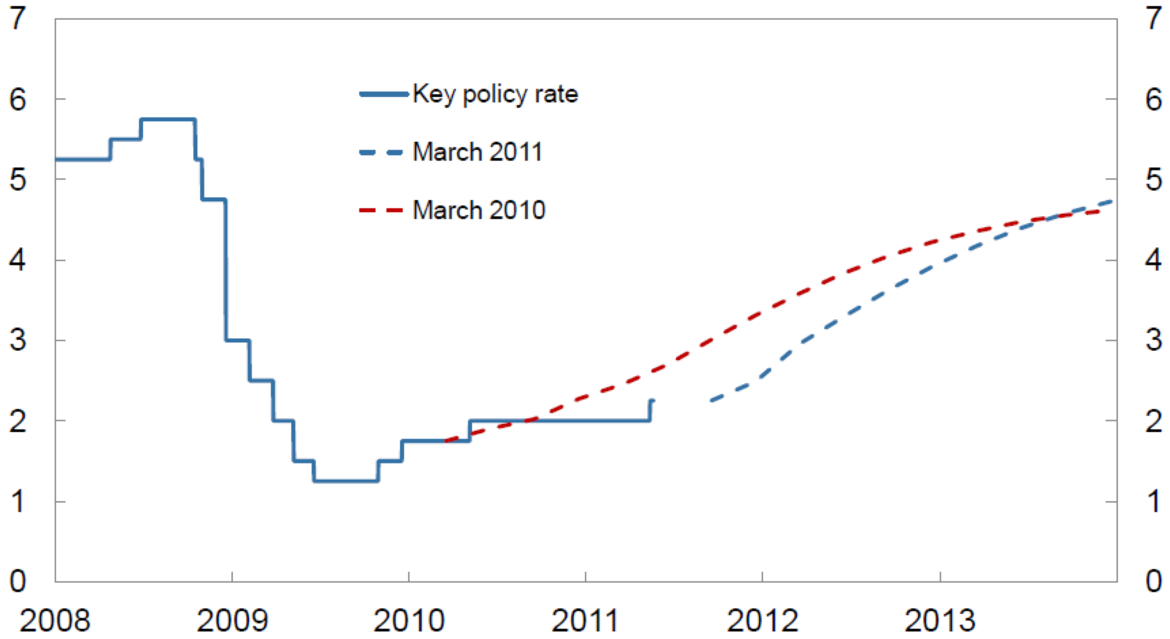



1) CPI adjusted for tax changes and excluding temporary changes in energy prices.

Sources: Statistics Norway and Norges Bank

## Key policy rate. Actual and projected

Per cent. January 2008–December 2013




Source: Norges Bank

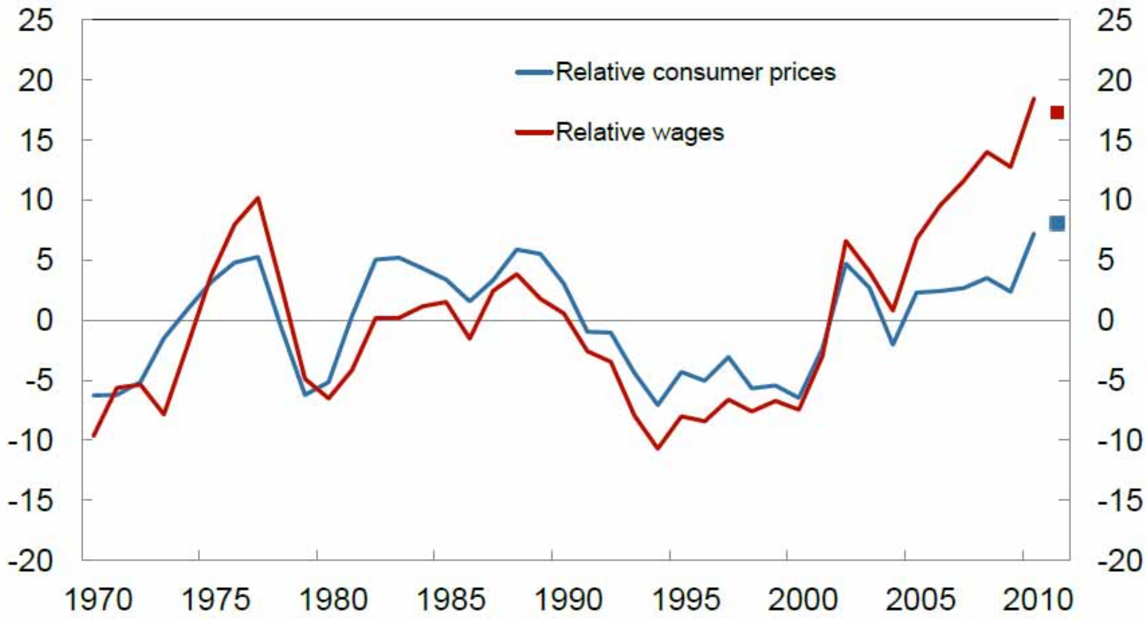
## Krone exchange rate

The import-weighted exchange rate index (I-44)
1 January 2008–18 May 2011


Source: Norges Bank

## Price and cost levels relative to trading partners

Per cent. Deviation from mean over the period 1970–2010. 1970–2011[1)]

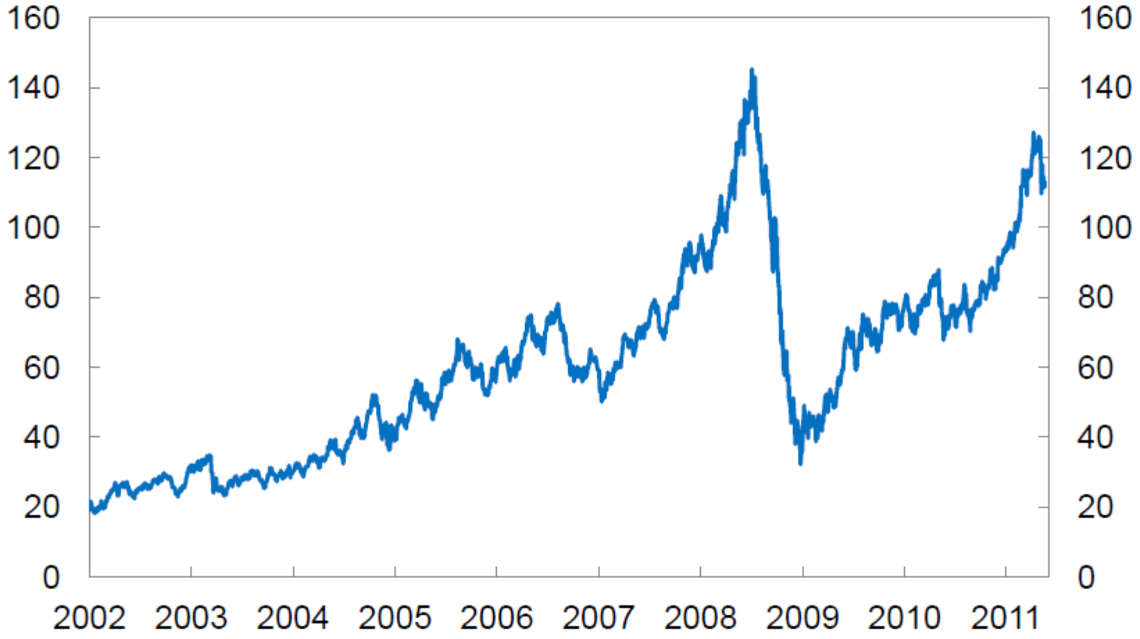



1) The squares show the average so far in 2011. A rising curve indicates weaker competitiveness

Sources: Statistics Norway, Technical Reporting Committee on Income Settlements, Ministry of Finance and Norges Bank

## Oil price (Brent Blend)

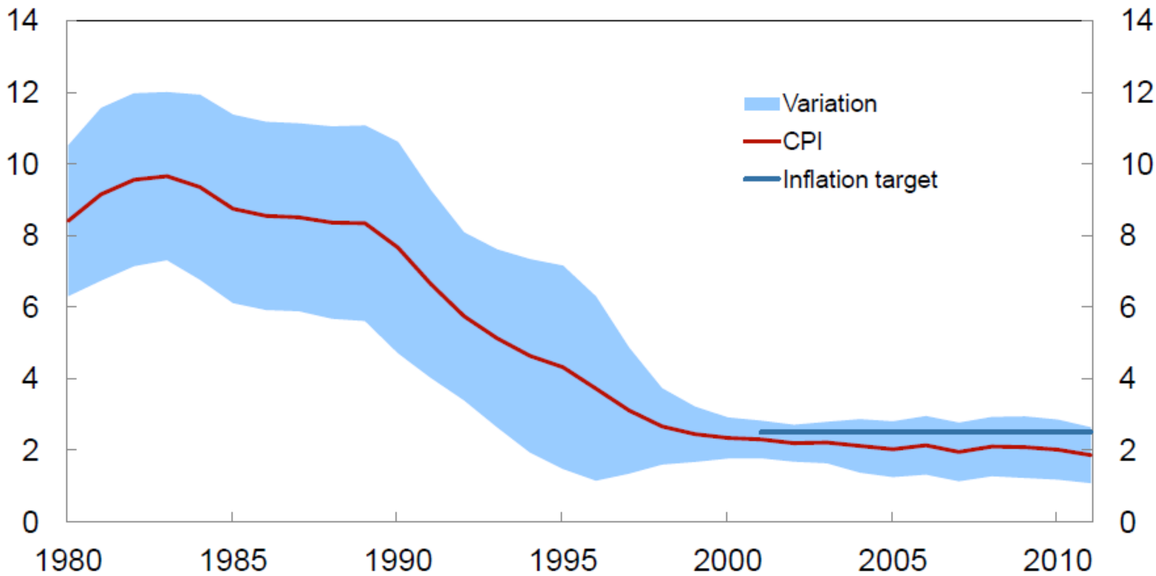
USD/barrel. Daily figures. 1 January 2002–18 May 2011




Source: Thomson Reuters

## Inflation

Moving 10-year average[1] and variation[2] in CPI[3]. Per cent. 1980–2011

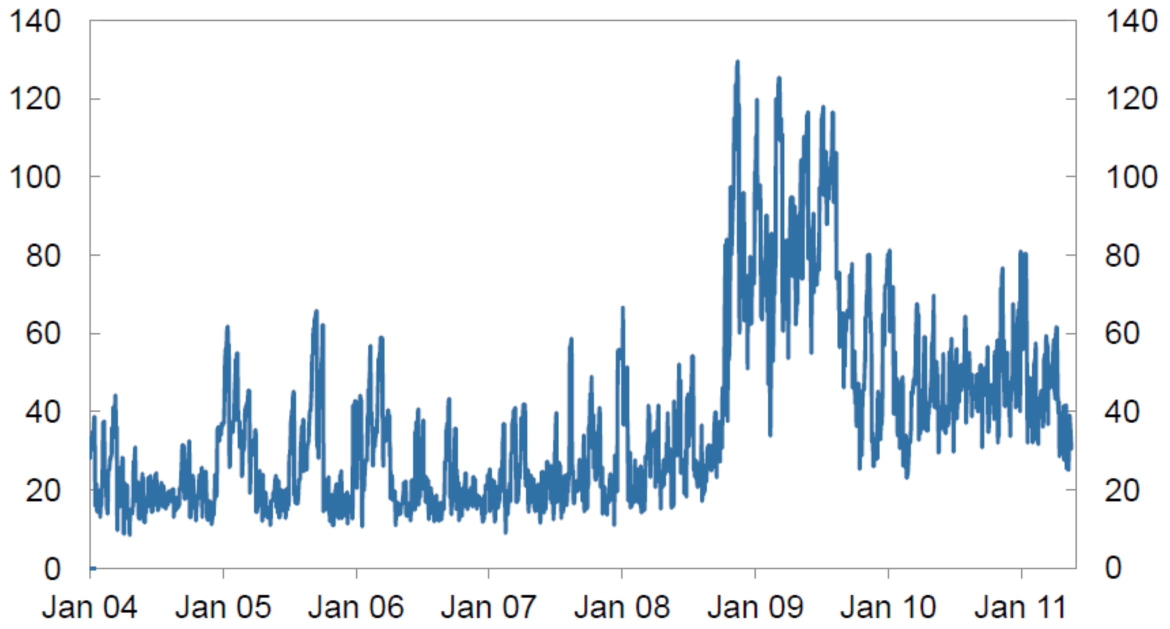



1) The moving average is calculated 10 years back
2) The band around the CPI is the variation in the CPI adjusted for tax changes and excluding energy products in the average period, measured by +/- one standard deviation
3) Estimate based on CPI projections from *Monetary Policy Report* 1/11

Sources: Statistics Norway and Norges Bank

# Surplus liquidity in the banking system

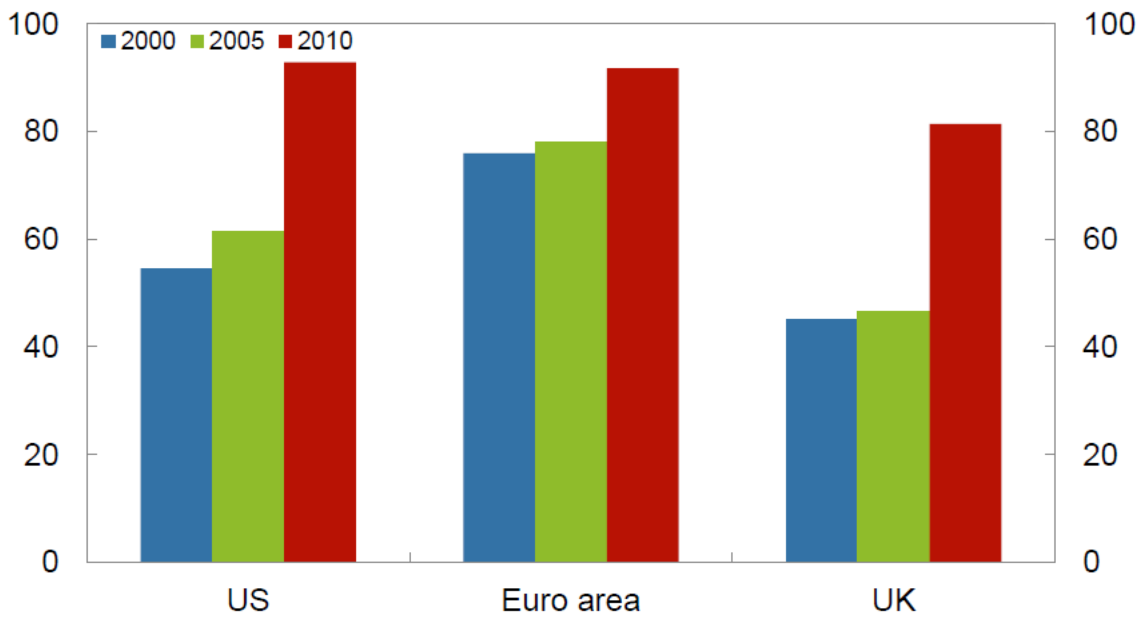
In billions of NOK. 1 January 2004–18 May 2011




Source: Norges Bank

# General government gross debt

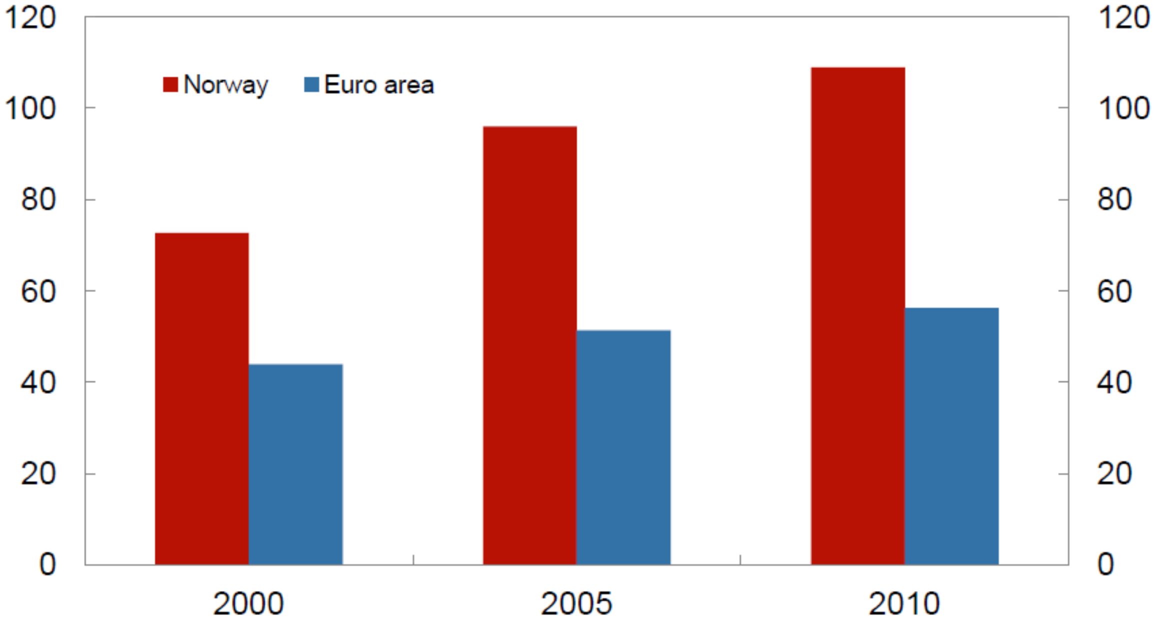
As percentage of GDP. 2000, 2005 and 2010[1)]




[1)] OECD projections for 2010

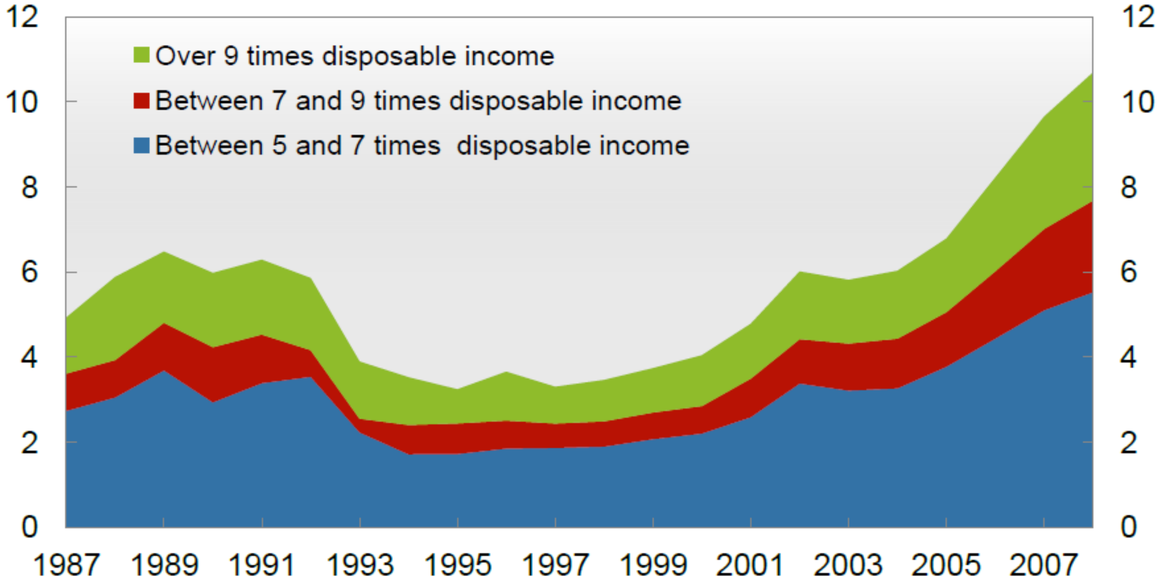
Source: OECD Economic Outlook 88

## Household debt
As percentage of GDP



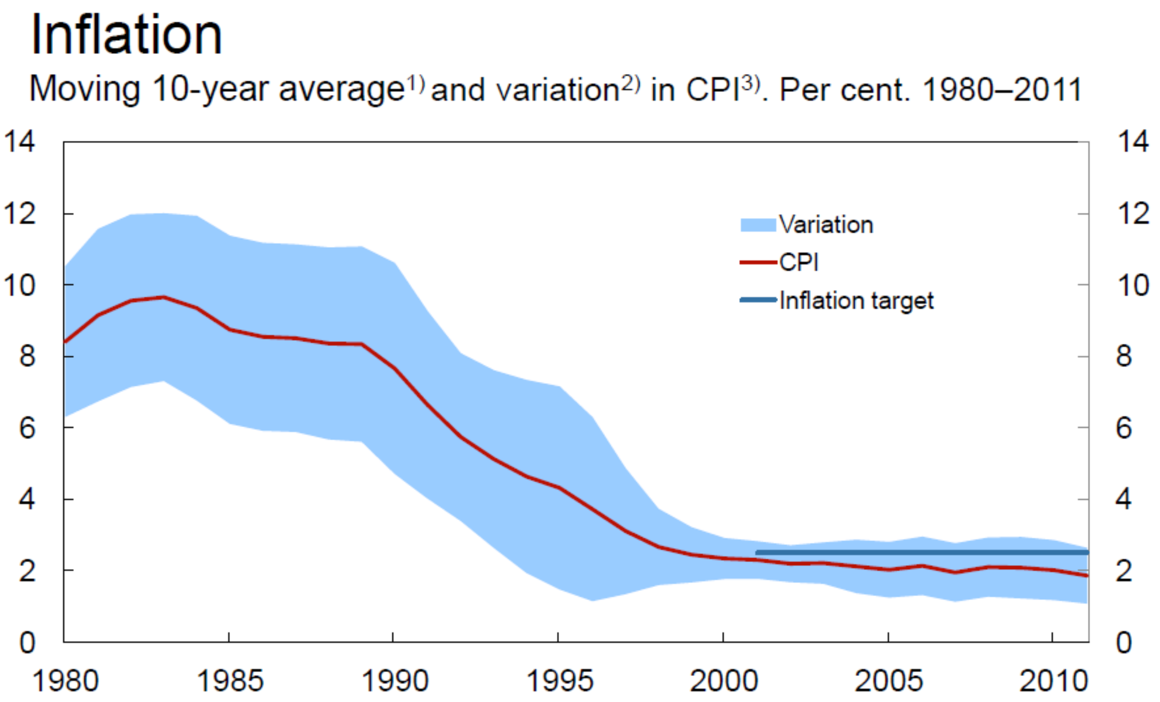

Sources: ECB, Thomson Reuters, Statistics Norway and Norges Bank

## Level of debt high for many households
Percentage of private households[1)] with net debt[2)] over 5 times disposable income. Annual figures. 1987–2008




1) Excl. self-employed
2) Net debt equals debt minus bank deposits

Sources: Statistics Norway and Norges Bank




1) The moving average is calculated 10 years back
2) The band around the CPI is the variation in the CPI adjusted for tax changes and excluding energy products in the average period, measured by +/- one standard deviation
3) Estimate based on CPI projections from *Monetary Policy Report* 1/11

Sources: Statistics Norway and Norges Bank